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IN THE

Supreme Court of the United States

OCTOBER TERM, 1928.

No. [redacted] 37

WABASH RAILWAY COMPANY, MYRON S. HALL, H. W. COHU, LaMOTTE COHU, GERALD V. HOLLINS, GEORGE R. LESLIE, EARLE KRAPP and WILLIAM FRASER DICKSON,

Petitioners,

v.

JOHN C. BARCLAY and WILLOUGHBY COMPANY,

Respondents.

BRIEF FOR RESPONDENTS AGAINST PETITION FOR WRIT OF CERTIORARI.

WILLIAM R. BEGG,
ELLIS AMES BALLARD,
JOSEPH S. CLARK,
Counsel for Respondents.

Pandick Press, Inc., 22 Thames St., New York, U. S. A.

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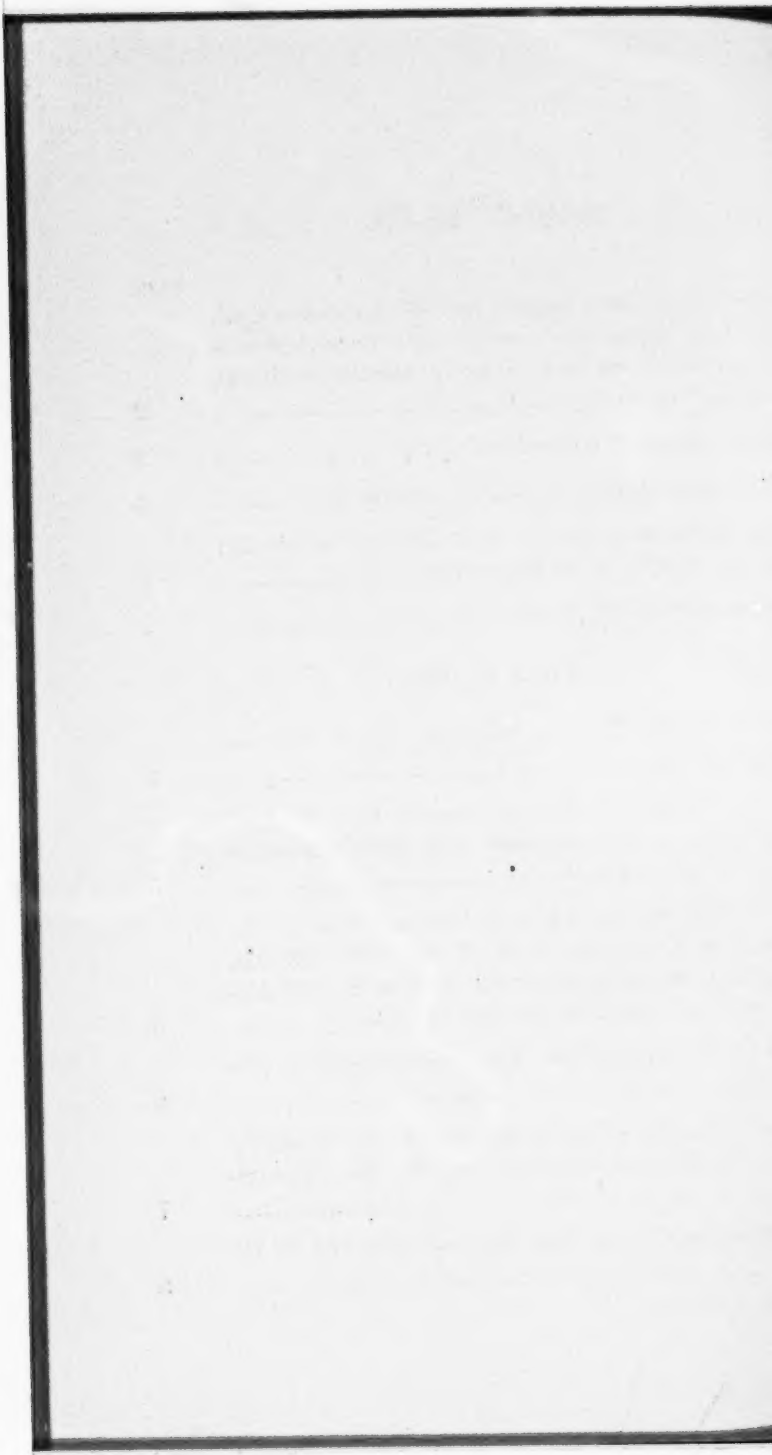

IN THE

Supreme Court of the United States

OCTOBER TERM, 1928

No. .

WABASH RAILWAY COMPANY, MYRON S. HALL, H. W. COHU, LAMOTTE COHU, GERALD V. HOLLINS, GEORGE R. LESLIE, EARLE KRAPP and WILLIAM FRASER DICKSON,

Petitioners,

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JOHN C. BARCLAY and WILLOUGHBY COMPANY,

Respondents.

BRIEF FOR RESPONDENTS AGAINST PETITION FOR WRIT OF CERTIORARI.

Two petitions for writs of certiorari have been filed in this case, one by the petitioners named above and another by Shirley P. Austin, the owner of common stock of the Railway Company. The basis for the petition filed by Austin is that the decision of the Circuit Court of Appeals is a decision in conflict with the decision of another Circuit Court of Appeals on the same matter. We have answered that point in the brief that we have filed against the writ of certiorari for which said Austin prays. The basis for the petition filed by the petitioners named above is the following question:

Is the Decision of the Circuit Court of Appeals a Decision of an Important Question of General Law in a Way Probably Untenable or in Conflict with the Weight of Authority?

This question divides itself into the following three points:

1. What was the question decided?

2. Was it an important question of general law?

3. Was the decision probably untenable or in conflict with the weight of authority?

We will consider these three points in their order.

What Was the Question Decided?

The question decided is very clearly set forth in the last paragraph of the opinion of the Circuit Court of Appeals (Record, p. 117). It called for the proper interpretation of the following charter provision of the Wabash Railway Company (Record, fols. 39-40):

> "The 5% profit-sharing Preferred Stock A shall be entitled to receive preferential dividends in each fiscal year up to the amount of 5% before any dividends shall be paid upon any other stock of this corporation, but such dividends on the 5% profit-sharing Preferred Stock A shall be non-cumulative." *

---

* This provision is quoted on pages 2-3 of the Petition, but there is a clerical error in the third line of the third page, the word "the" being substituted for the word "any", making the clause read "upon *the* other stock of the Company" instead of "upon *any* other stock of the Company".

This charter provision expresses two points: (a) the amount of the preferential dividend the A stock is entitled to receive in each year and (b) the preference in payment given to said dividends. The amount of the dividend for each year is determined by the phrase "up to the amount of 5%" but this phrase does not definitely state the amount. It may be 5% or it may be less. The word "non-cumulative" fills in the gap. That word when used to define preferred dividends means "dependent upon the earnings of each particular year". This was decided as long ago as 1886 in the case of *New York, Lake Erie & Western R. R. Co.* vs. *Nickals*, 119 U. S. 296, in which the Court said, in speaking of non-cumulative dividends:

> "non-cumulative because dependent upon the earnings of each particular year."

We do not believe that petitioners will deny that the word "non-cumulative" when used in this connection has this meaning. They argue that it has a further meaning, which is, that a non-cumulative preferred dividend for a particular year, although earned in that year, if not paid out of the earnings of the year, cannot be charged against the earnings of any subsequent year. It is true that if a non-cumulative preferred dividend for a particular year is not earned in that year, there is a deficiency of earnings to cover the year's dividend and that deficiency cannot be charged against the earnings of any subsequent year. That deficiency is lost to the stockholders. This is the difference between a cumulative and a non-cumulative dividend. If the dividend is cumulative the deficiency is chargeable against subsequent earnings.

This question is interesting and the difference is well established by the authorities. The point, however, is not

involved in the present case. The Circuit Court of Appeals said nothing about any charge or preference in favor of the A dividends upon subsequent earnings or any other moneys of the company. It held that the preferred dividend credit must be liquidated before any junior dividends could be paid, without any reference to the funds which might be appropriated to accomplish such liquidation.

It will be appreciated that this point relates to the preference given to the A dividends, for the question is whether earned but unpaid A dividends for prior years are entitled to a preference in payment over junior dividends. The preference given to the A dividends is defined in the charter provision by the words "preferential dividends" and the further statement that the Preferred A stock is entitled to receive its dividends "before *any* dividends shall be paid upon any other stock of the Company." Upon this question of preference the Circuit Court of Appeals held that the word "non-cumulative" had no bearing. There is nothing to indicate that the dissenting Judge differed with the majority of the Court on this point.

The foregoing discussion shows the nature of the question which was decided by the Circuit Court of Appeals and which is clearly set forth in the last paragraph of its opinion (Record, p. 117).

Was It an Important Question of General Law?

In all contracts of this kind the preference depends upon the provisions of the contract which define it. We deny that the word "non-cumulative" has any influence in determining the extent of the preference. That word has no influence except to determine the *amount* of the dividend which the A stock is entitled to receive. If on this point

we are in error and petitioners are right, it follows that in the interpretation of each contract of this kind the word must be read in connection with the other language of the contract which defines the preference. The question therefore becomes a question of the proper interpretation of each particular contract rather than "an important question of general law". This was the view taken by the Judge who filed the dissenting opinion in the Circuit Court of Appeals. He based his dissent upon a few words in the contract which he quoted at the beginning of his opinion (Record, p. 118). He did not consider the word "non-cumulative" of any importance, for he did not mention it at any point in his opinion.

Was the Decision Probably Untenable or in Conflict With the Weight of Authority?

This decision was the natural result of giving the word "non-cumulative" the same meaning which was given to it by this Court in the Nickals case in 1886 and in numerous decisions cited and discussed in the opinion of the Circuit Court of Appeals in support of its conclusion (Record, pp. 103-117). The same and other cases were cited and discussed in the opinion of the Circuit Court of Appeals for the Ninth Circuit in the case of *Collins* vs. *Portland Electric Power Co.*, 12 Fed. (2nd) 670, and in the opinion of Wolverton, D. J., in the same case, reported in 7 Fed. (2nd) 221, and both courts reached the same conclusion.

Particular attention is called to the Cast Iron Pipe and Foundry cases in New Jersey, which are fully discussed in the above opinions. Petitioners in their brief (p. 20) dispose of these cases by saying that they arose under a New Jersey statute which abridged the ordinary directorial dis-

cretion. The statute did not affect the decisions in so far as they defined the meaning of the word "non-cumulative". One of these cases, entitled *Day* vs. *U. S. Cast Iron Pipe and Foundry Co.*, is spoken of in the dissenting opinion (Record, p. 119), and the statement is there made that it was decided by an evenly divided Court. The Court evidently divided, not upon the interpretation of the word "non-cumulative", but upon another provision of the contract which authorized payment of common dividends. There is no such provision in the Wabash contract.

In the present case we are not contending that the ordinary directorial discretion of the Board has been abridged. The Board has full authority to appropriate the earnings of any year for any proper corporate purpose. When, however, the Board determines to pay dividends, the contract defining the dividend rights of the several classes of stockholders controls and determines which class of stockholders is entitled to receive the dividend.

Notwithstanding all of these decisions petitioners contend that the decision of the Circuit Court of Appeals is a decision of an important question of general law in a way probably untenable or in conflict with the weight of authority. In support of this contention they cite the following two decisions of this Court: *New York, Lake Erie & Western R. R. Co.* vs. *Nickals*, 119 U. S. 296 (1886), and *Continental Insurance Co.* vs. *United States*, 259 U. S. 156 (1922).

In the Nickals case preferred stockholders whose dividends were designated "non-cumulative" brought suit to force the Company to pay their dividends which had been earned in a prior year. It appeared that the Board had appropriated the earnings of that year to pay for much needed extensions and improvements. The contract provided that the dividends should be payable "as declared by

the Board". The Court held that the Board was vested with a proper discretion to appropriate the earnings for the purposes indicated and dismissed the bill. If in the present case the A stockholders were demanding payment of their earned dividends for prior years, the Nickals case would be in point. They are not demanding payment, but are asking for an injunction to prevent the payment of junior dividends until their dividend credit is liquidated. The preferential right of the preferred to receive dividends before common dividends could be paid was not presented in the Nickals case. The Court, however, in the course of its discussion said that the preferred stockholders were entitled to their dividends "in advance of the common stockholders". The fact that the dividends were non-cumulative had nothing to do with the conclusion. It would have been the same if the dividends had been cumulative. The Court defined the word by stating "non-cumulative because dependent on the profits of each particular year".

In *Continental Insurance Co.* vs. *United States, supra,* it appeared that the Company had issued non-cumulative preferred and common stocks, but the dividend rights of the preferred were not involved. The point decided was that earnings made over a long period of years, which prior to dissolution might have been used to pay common dividends, must upon dissolution be considered as capitalized and distributed as capital. The meaning of the word "non-cumulative" was not discussed or involved. In the present case there has been no capitalization of the earnings of prior years, which might have been paid as Preferred A dividends instead of being appropriated to increase the working capital, or to pay the cost of extensions and additions. On this point see the very recent case of *People of Colorado ex rel. Fraser* vs. *Great Western Sugar Co.,* in

the Circuit Court of Appeals for the Eighth Circuit, decided December 1, 1928, 29 Fed. (2nd) 810, Advance Sheets of February 14, 1929.

Petitioners also cite the case of *Star Publishing Co.* vs. *Ball*, 192 Ind. 158, 104 N. E. 283, and argue that the decision is in conflict with the decision of the Circuit Court of Appeals in the present case. In that case preferred stockholders whose dividends were non-cumulative demanded payment of dividends which had been earned in prior years, but still remained unpaid. They amounted to $62,125, but the Court ordered payment of $39,050 only, leaving the balance, to-wit: $23,075 unpaid and explained that fact by stating that the record failed to show the amount required for working capital and therefore it did not reverse the Trial Court and order payment of this balance. It expressly held, however, that failure to pay an earned non-cumulative preferred dividend for prior years and the appropriation of the earnings of that year for other proper corporate purposes operates as a suspension only of the right of the preferred stockholders to receive those dividends. This case is fully discussed in the opinion of the Circuit Court of Appeals and also in the opinion in the Portland case. Petitioners call attention to the fact that although the Court failed to order payment of this balance of earned but unpaid dividends for prior years, it approved payment of a participating dividend to the preferred and common stockholders and therefore approved payment of common dividends before all of the earned but unpaid preferred dividends for prior years were paid and satisfied. It appeared that this participating dividend had been ordered by the Trial Court and evidently no assignment of error on that point had been filed by the preferred stockholders, for the point was not discussed by the appellate

court and was mentioned incidentally only. It further appeared that the bill did not ask for an injunction to restrain the payment of common dividends and, in addition, that the question whether the preference given the preferred dividends was a preference upon the earnings of subsequent years was not mentioned.

Petitioners' point that the decision of the Circuit Court of Appeals is probably untenable or in conflict with the weight of authority cannot be sustained. .

Other Non-cumulative Stocks.

Petitioners cite a long list of non-cumulative preferred stocks which they say may be affected by the decision of the Circuit Court of Appeals (Petition, p. 4). They state that the fact that so many non-cumulative preferred stocks are outstanding indicates the great importance of the question presented and the wide-spread interest in it. Although this may be true, that fact does not indicate that the decision of the Court of Appeals is "probably untenable or in conflict with the weight of authority". It may be that petitioners' reason for citing this list of non-cumulative preferred stocks was that at one time there was propounded in certain financial circles a theory that a non-cumulative preferred dividend for a particular year, if not declared within the year, is lost to the stockholders; that the declaration and payment of any such dividend is a matter of discretion with the Board, and that if such declaration and payment should be postponed beyond the end of the year all right to the dividend for that year is gone. We believe it is true that a theory of that kind was discussed, but it is now an exploded theory. It is not even presented by petitioners.

Petitioners, however, do present a corollary to that theory, which is that the only fund out of which a non-cumulative preferred dividend for a particular year may be paid is the earnings of that year and if those earnings are appropriated by the Board for other proper corporate purposes, such as payment for constructions of extensions and improvements, nothing is left for the stockholders for that year's dividend unless it be a frozen credit which may never be liquidated by the Company. Neither this theory nor its corollary has ever had any support in the authorities.

There is no reason to believe that the holders of these other preferred stocks are not and were not advised of the true meaning of the word "non-cumulative" when used to define preferred dividends. The interpretation placed upon that word by the Circuit Court of Appeals is not a new interpretation.

In petitioners' discussion of these other preferred stocks (Petition, pp. 6-7) the statement is made that the two Judges of the Circuit Court of Appeals who concurred in the decision are on one side of the issue and the dissenting Judge and the District Judge are on the other side. The dissenting Judge did not disagree with the other two Judges of the Circuit Court of Appeals upon the proper meaning of the word "non-cumulative". He said at the beginning of his opinion (Record, p. 118) "The relevant clause of the charter gives the plaintiffs preferred* dividends in each fiscal year up to the amount of 5%". He held that the words quoted from the contract are words of limitation as well as grant and that the preference given the

* In this quotation which appears on page 118 of the Record the word "preferred" was inadvertently substituted for "preferential". The meaning is of course the same.

A dividend for each year is a preference upon the earnings of that year only. He does not undertake to define the meaning of the word "non-cumulative". That word is not mentioned at any point in his opinion. On the main issue, therefore, we have the two Judges who concurred in the opinion of the Circuit Court of Appeals on the one side and Winslow, D. J., on the other. Why should we leave out the Judges who decided the Portland case in the Ninth Circuit? All three Judges in the Circuit Court of Appeals concurred in affirming the decision of Wolverton, D. J. We have therefore these four Judges to add to the two who concurred in the opinion of the Circuit Court of Appeals in the present case, and the figures therefore show six in favor of respondents against one only, that is, Winslow, D. J., in favor of petitioners.

In conclusion respondents rely with confidence upon the full and careful opinion filed by the Circuit Court of Appeals and we respectfully submit that the petition should be denied.

William R. Begg,
Ellis Ames Ballard,
Joseph S. Clark,
Counsel for Respondents.

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CHARLES ELM

IN THE

Supreme Court of the United States

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No. [redacted]38

SHIRLEY P. AUSTIN,
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vs.

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BRIEF FOR RESPONDENTS AGAINST PETITION FOR WRIT OF CERTIORARI.

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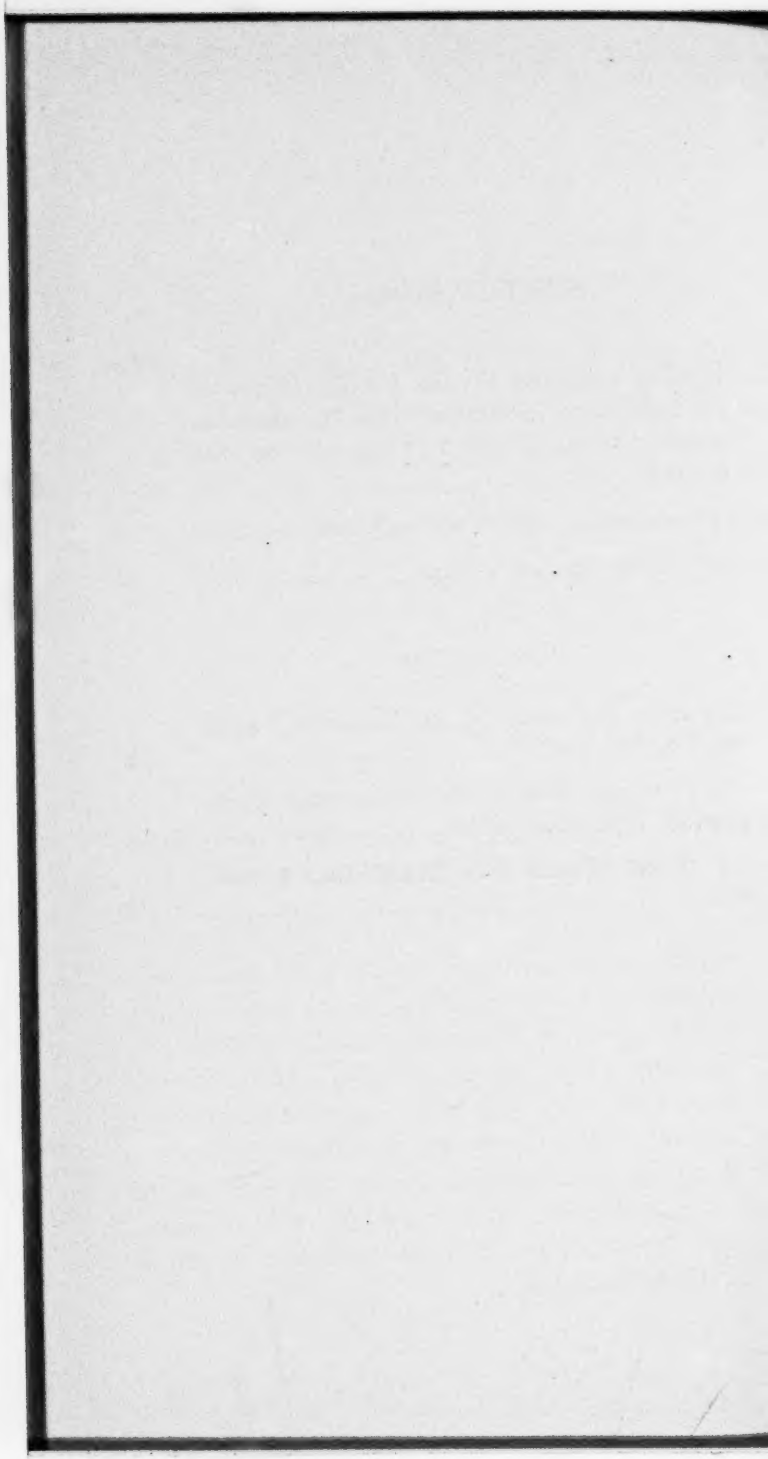

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OCTOBER TERM, 1928.

No. .....

SHIRLEY P. AUSTIN,
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vs.

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Respondents.

BRIEF FOR RESPONDENTS AGAINST PETITION FOR WRIT OF CERTIORARI.

Two petitions for writs of certiorari have been filed in this case, one by the petitioner named above and another by Wabash Railway Company, *et al.* The basis for the petition filed by the Railway Company, *et al.*, is that the decision of the Circuit Court of Appeals was a decision of an important question of general law in a way probably untenable or in conflict with the weight of authority. We have answered that point in the brief that we have filed against the writ of certiorari for which said Railway Company, *et al.*, pray. The basis for the petition filed by Shirley P. Austin is the following point:

IS THE DECISION RENDERED BY THE CIRCUIT COURT OF APPEALS A DECISION IN CONFLICT WITH THE DECISION OF ANOTHER CIRCUIT COURT OF APPEALS ON THE SAME MATTER?

In the brief submitted in support of the petition filed by Shirley P. Austin the case of *Missouri Pacific Raliroad Co.* vs. *Texas & Pacific Railway Co.*, 282 Fed. 61, decided by the Circuit Court of Appeals for the Fifth Circuit is cited and it is argued that the decision of the Circuit Court of Appeals in the present case is in conflict with said decision of the Circuit Court of Appeals for the Fifth Circuit, which settled the rights of income bondholders to non-cumulative interest for prior years. The fact that the interest was designated non-cumulative was not considered of any importance. The word "non-cumulative" was mentioned incidentally only. The decision was rested upon the peculiar language of the contract, coupled with the long continued practical construction of that language. That decision in the Fifth Circuit is therefore not in conflict with the decision of the Circuit Court of Appeals in the present case. There is a decision on the same matter in the Circuit Court of Appeals for the Ninth Circuit. It is the case of *Collins* vs. *Portland Electric Power Company* and *Kurtz* vs. *Same,* 12 Fed. (2nd) 671, affirming the decision of Wolverton, D. J., reported in 7 Fed. (2nd) 221. The only comment made upon that case by petitioners (see their brief, p. 20) is that it is inconclusive and does not touch the fundamental question decided by the Circuit Court of Appeals. We are not in accord with that view. We submit that the opinions in the Portland case contain a full and accurate discussion of the questions decided by the Circuit Court of Appeals in the present case and it was expressly

decided that the preferred stockholders, whose dividends were non-cumulative, were entitled to enjoin the payment of common dividends until after all of the earned dividends for prior years were first paid and satisfied.

Reasons Presented for Review Not Sufficient.

Petitioner sets forth various reasons for the review by this Court of the decision of the Circuit Court of Appeals. The public interest and the disturbance of vested property rights and the accounting problems and the destruction of stock exchange markets for non-cumulative preferred stocks are much exaggerated. It is fair to assume that the dividend credit in favor of the Preferred A stockholders, which was approved by the Circuit Court of Appeals, was a credit for the benefit of all of the preferred stock, including that which has been issued since the credit was created. If no such additional stock had been issued this point could not be made. There is no reason to doubt that full justice will be done to all of the Preferred A stockholders if this petition is denied, but if we admit that these points are important, that fact does not call for a review of the case by this Court. It must, in addition, be shown that there is a conflict between the decision of the Circuit Court of Appeals in the present case and the decision of some other Circuit Court of Appeals on the same matter or that the case qualifies under some other class defined in Rule 38, Section 5.

Important Reason Against Review.

A more important argument in favor of the decision of the Circuit Court of Appeals is that, if that decision should be reversed, directors, if owning more common stock than

preferred, will be in a position to postpone payment of preferred dividends and appropriate the earnings to pay the cost of additions and improvements and to increase the working capital and, when the earnings are very materially increased thereby, to declare dividends out of current earnings, giving to the preferred only its current preferential dividends and to the junior stocks increased and increasing dividends, while for its back dividends the preferred must rest satisfied with a frozen credit, secured only upon the increased working capital and the ties, rails and terminal facilities acquired through the appropriation of earnings for such purposes, which the Board might have used to pay preferred dividends. An interpretation of a contract which leads to such conclusions will not be accepted by a court of equity if any other reasonable interpretation can be suggested. *Henry* vs. *Great Northern Railroad Co.*, 1 deG. & J. 606.

We respectfully submit that the petition should be denied.

WILLIAM R. BEGG,
ELLIS AMES BALLARD,
JOSEPH S. CLARK,
Counsel for Respondents

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SHIRLEY P. AUSTIN,
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vs.

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Respondents.

BRIEF ON BEHALF OF RESPONDENTS.

WILLIAM R. BEGG,
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ELLIS AMES BALLARD,
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Pandick Press, Inc., 22 Thames St., New York, U. S. A.

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OCTOBER TERM, 1929.

WABASH RAILWAY COMPANY, MYRON S. HALL, H. W. COHU, *et al.*, Petitioners, *vs.* JOHN C. BARCLAY and WILLOUGHBY COMPANY, Respondents.	No. 37
SHIRLEY P. AUSTIN, Petitioner, *vs.* JOHN C. BARCLAY and WILLOUGHBY COMPANY, Respondents.	No. 38

BRIEF FOR RESPONDENTS.

Statement.

We accept statement of the underlying facts set forth in petitioners' brief, pages 4 to 8, except only in two particulars, which are as follows:

1. In the middle of page 5 the preferential dividend right given to the Preferred Stock A by the charter is para-

phrased and the language is not exactly the same as the language of the contract. The exact language is important; and

2. In the sixth line of page 6 the word "dividend" appears. In the contract the word is "dividends", that is, the plural instead of the singular.

The rights of the parties depend upon the proper interpretation of the charter provision or contract which defines the dividend rights of the Preferred A Stock. This contract is set forth at the beginning of Article 4th of the Certificate of Incorporation of the Railway Company (Transcript, p. 10) and reads:

> "The Five Per Cent. Profit-Sharing Preferred Stock A shall be entitled to receive preferential dividends in each fiscal year up to the amount of five per cent. before any dividends shall be paid upon any other stock of this corporation, but such dividends on the Five Per Cent. Profit-Sharing Preferred Stock A shall be non-cumulative."

The Petitioners and the Respondents differ in regard to the proper meaning of the word "non-cumulative", which is the last word in the above quotation, and also the proper meaning of the other language of the quotation.

ARGUMENT.

The primary purpose of the provision quoted above is to vest in the Preferred Stock A the right to receive preferential dividends in each year up to the specified amount, payable before any junior dividends shall be paid. Respondents are of the opinion that the only particular difficulty that arises in the interpretation of the provision is to determine the meaning of the word "non-cumulative".

Wherever in the quotations hereinafter inserted any words are italicized the italics are ours unless otherwise stated.

I.

What is the meaning of the word "non-cumulative" when used to define preferred dividends?

This word defines the amount of the dividend which the preferred stockholders are entitled to receive in and for each year. That amount is dependent upon the earnings of the year. The difference between cumulative and non-cumulative preferred dividends has been the subject of inquiry and discussion in a great many text books and cases. The point of difference relates to the right of the stockholders to receive dividends for any year in which the Company has failed to earn said dividends either in whole or in part. Cumulative preferred dividends must be paid before junior dividends, regardless of the year in which they are earned. This is not true of non-cumulative preferred dividends. If they are not earned in any year, or to the extent that they are not earned in any year, the stock-

holders are not entitled to receive dividends for that year. The deficiency cannot be made up out of the surplus earnings of any subsequent year. Non-cumulative preferred dividends, however, to the extent that they are earned year by year, must be paid before junior dividends are paid.

This difference between cumulative and non-cumulative dividends is well settled by the authorities.

In *Machen on Corporations,* 1908 Edition, Section 551, the author says:

> "Section 551. *Whether Preference is Cumulative.* The first question usually raised as to the preferential dividend is whether the preference is cumulative or not. That is to say, when preferred shares carry a preferential dividend of a certain rate per cent. *per annum,* are they entitled to claim that if the profits of one year are not sufficient to pay that dividend in full, the deficiency must be made good out of the profits of the next or some succeeding year before anything can be paid to the holders of the common shares? If so, the preferred shares are said to be cumulative preferred shares; if not, they are said to be non-cumulative."

The point of difference between cumulative and non-cumulative dividends relates to the right of the stockholders to receive dividends for any year to the extent that they are not earned in that year. The unearned part represents the deficiency. If the dividend is cumulative that deficiency must be made good out of the earnings of subsequent years before junior dividends are paid. The difference relates to the status of the deficiency as distinguished from the status of the earned part of the dividend. If the dividend for any year is earned in that year and there is no deficiency it makes no difference whether the divi-

dends are cumulative or non-cumulative. The amount of a non-cumulative preferred dividend for any year which the stockholders are entitled to receive is the amount earned on account of that dividend in that year.

In *Palmer's Company Precedents*, Part I., 1912, 11th Ed., the author says on page 812:

> "The term 'cumulative preferential dividend' means a dividend payable out of the profits generally in priority to the subordinate class or classes of shares, so that if the profits of one year are not sufficient to pay the dividend for that year, the deficiency accumulates as against subsequent profits, and has to be cleared off before any dividend can be paid on the subordinate class or classes. On the other hand, a non-cumulative preferential dividend means a dividend payable as regards each year out of the profits of that particular year only in priority to the subordinate class, so that if the profits of the year are insufficient, the deficiency is extinguished instead of being carried forward as against subsequent profits."

Note that the deficiency accumulates if the dividend is cumulative, but that the deficiency is extinguished if the dividend is non-cumulative.

In *Palgrave's Dictionary of Political Economy*, Vol. I., (1894), under the heading "Dividend on Stock and Shares", pp. 606-607, we find the following:

> "It is generally stated in the articles whether preference shares are to be cumulative—that is to say, whether a deficiency in dividend arising from insufficiency of profits in one year is to be made good out of profits of subsequent years, or whether preferential dividends are to be paid out of the profits of each year only—non-cumulative dividend."

That deficiency is again mentioned showing that the difference between "cumulative" and "non-cumulative" relates to the status of the deficiency.

In *Clark and Marshall on Corporations,* Section 529-d, we find the following:

> "Sometimes the dividends upon preferred stock are in express terms made to depend upon the profits of each particular year, so that the holders of the stock will not be entitled to any dividends in a particular year if there are not enough profits in that year to pay the same, or will be entitled only in so far as there are profits. In such a case the dividends are not cumulative, and are not to be made up out of the profits, although sufficient, of subsequent years."

In *Staples* vs. *Eastman Photographic Materials Co.*, 65 L. J. Ch. N. S. 682 (1896), L. R. 2 Ch. Div. 303, the Court said:

> "HELD (reversing the decision of Chitty, J.) that the preference shareholders were not entitled to a cumulative dividend of 10 pounds per cent so as to have the deficiency in one year paid out of the profits of a subsequent year before paying anything to the ordinary shareholders."

Note again the use of the word "deficiency."

The preferred dividend was not designated "non-cumulative," but it was made payable "out of the net earnings of each year". The case was discussed in Palmer's Company Precedents, page 813 and at that point the author said:

> "See Staples *vs.* Eastman &c. Co. (1896) 2 Ch. 303, in which case a dividend was held to be non-cumulative although the wording of the clause was ambiguous."

In *Day* vs. *United States Cast Iron Pipe & Foundry Co.* in the New Jersey Chancery Court, 95 N. J. Eq. 389, 123 Atl. 546 (1924), affirmed by the Court of Errors and Appeals by a divided court, 96 N. J. Eq. 736, 126 Atl. 302 (1924), the Vice Chancellor, in considering the discretionary power of the directors to declare dividends, said:

> "They are at liberty to pass dividends year after year and pile up profits, if in their opinion it is for the welfare of the company that this be done—as was done here—and in the absence of fraud, actual or constructive, their judgment is controlling. But once having decided to divide the profits, duty supplants discretion, and it becomes incumbent upon the directors to discharge the company's obligation to pay the fixed yearly dividends, and this before any dividend shall be set apart or paid on the common stock, viz.: To holders of cumulative dividend shares, all arrearages; to holders of non-cumulative dividend stock, the dividends withheld. Otherwise, if the action of the defendant company were sanctioned, and the directors pursued the course they have outlined, the rights of the preferred stockholders in the reserve profits could be indefinitely ignored and altogether subordinated to those of the common stock. Although each class has a definite sum in the reserve and one cannot encroach on the other's for dividends, the preferential right of payment of dividends assured by the statute cannot be disregarded. The statutory design was to meet just such a situation as here confronts the preferred stockholders. The legislative scheme was to protect them in their priority rights to dividends over the common stock in all events, and where, as here, profits of past years applicable to dividends on both preferred and common stock are held in reserve, or there are current profits applicable to dividends on

common stock, it was conceived that this protection would be afforded for forbidding the payment of any dividends on the common stock until the amount due the preferred stockholders was first paid. The statute in this respect is nothing more or less than a definition of the equitable rights of the preferred stockholder arising out of the company's obligation to pay the yearly fixed dividend, for if the company had profits not needed in its business, and was about to distribute them among the common stockholders when it owed dividends on the preferred stock, a court of equity would enjoin the diversion, just as it would intervene in behalf of creditors of a corporation when dividends are in derogation of their rights."

In the Court of Errors and Appeals Judge White said:

"* * * in the absence of refining differences of designation and preferences, and restrictions and qualifications thereof, preferred stock, so far as the payment of dividends is concerned, may, speaking generally, be said to embrace cumulative preferred stock and non-cumulative preferred stock, the distinction between the two being that, while dividends (not in liquidation) upon each can, of course, only be paid out of profits or surplus (*McGregor* v. *Home Ins. Co.*, 33 N. J. Eq. 181; *Mills* v. *Hendershot*, 70 N. J. Eq. 258; 62 Atl. 542); the dividends upon cumulative preferred stock have at all times and for all years past and present, until paid, priority in payment over any and all unpaid dividends upon common stock, whether the net earnings for any particular past or present year were or were not sufficient to pay the stipulated cumulative dividends upon preferred stock for that year; whereas the like priority of dividends upon non-cumulative preferred stock (wholly or partially, as the case may be) is limited

> to the unpaid dividends for those years when such net earnings were sufficient (wholly or in corresponding part) to pay such dividends. This distinction renders it self-evident that the suggestion made by counsel that complainant is contending for cumulative preferred stock rights for his non-cumulative preferred stock, is without merit."

Petitioners undertake to distinguish the Cast Iron Pipe and Foundry Company cases in the New Jersey Courts on the ground that these decisions were influenced by two New Jersey statutes. We are not in accord with that view. In the above quotation from the decision of the Vice-Chancellor in the *Day* case, note the statement near the end that the statute "is nothing more or less than a definition of the equitable rights of the preferred stockholders". In the absence of a statute, the result in a Court of Equity will be the same. Note also the statement in the early part of the decision of Judge White in which "speaking generally" he defines the difference between cumulative and non-cumulative preferred stock. The interpretation placed by these two courts upon the word "non-cumulative" when used to define preferred dividends was not influenced by the provisions of any statute.

In *New York, Lake Erie & Western R. R. Co.* vs. *Nickals*, 119 U. S. 296, 30 L. Ed. 363 (1886), the word "non-cumulative" was defined as follows:

> "non-cumulative because 'dependent on the profits of each particular year', and not to be fastened on the profits of succeeding years."

In *Dent* vs. *London Tramways Co.*, L. R. 16 Ch. Div. 344 (1880), Sir George Jessel gives a very good illustration of the meaning of a preferred dividend which is dependent

upon the earnings of the year. The contract considered provided that the dividends should be

> "dependent upon the profits of the particular year only."

This means that the preferred dividends were non-cumulative. The Court, speaking through Sir George Jessel, M. R., said after quoting these words:

> "That means this, that the preference shareholders only take a dividend if there are profits for that year sufficient to pay their dividend. If there are no profits for that year sufficient to pay their dividend, they do not get it; they lose it forever; and if there are no profits in one year, and 12% profit the next year, they only get 6%, and the other 6% goes to the ordinary shareholders. So that they are, so to say, co-adventurers for each particular year, and can only look to the profits of that year."

See also:

Belfast & M. L. R. Co. vs. *Belfast,* 77 Maine 445; 1 Atl. 362, and again same case, 79 Maine, 411, 10 Atl. 328;

Fletcher's Cyc. of Corporations (1919), Vol. 6, Sec. 3754;

Berle, Studies in the Law of Corporation Finance, Chapter V.;

Three law review articles on non-cumulative dividends, one in 23 Columbia Law Review, page 358 (1923); a second in 11 Va. Law Review, page 553 (1925), and the third in University of Pennsylvania Law Review, Vol. 74, page 605 (1926).

On this branch of the case we submit the following conclusions:

1. All dividends are dependent upon earnings.

2. Cumulative dividends are not dependent upon the earnings of any particular year. If there is a deficiency in any year the full dividend for the year, notwithstanding the deficiency, accumulates with and will be made up out of the earnings of subsequent years. Dividend credit for that year, to the extent of the full specified dividend, is given to the stockholders and the aggregate of the dividend credits for all of the years must be first paid and satisfied before any junior dividends may be paid.

3. A non-cumulative dividend is dependent upon the earnings of each year. If not earned in any year in whole or in part the deficiency cannot be accumulated with and made up out of subsequent earnings. The stockholders are entitled to a dividend credit for that year to the extent only that it is earned within the year.

Petitioners, as we understand their position, agree to points 1 and 2, but not to point 3. They contend that the Board in the absence of an abuse of discretion (and no such abuse is claimed in the present case) has a large measure of control over non-cumulative dividend rights and preferences. They claim:

> (a) That non-cumulative dividend rights depend on dividend declarations and that an inchoate and unenforceable dividend right only is created by the contract.
>
> (b) A non-cumulative dividend for a particular year, even though earned in that year, is lost to the stockholders unless the dividend is declared within the year.

(c) Even though a non-cumulative dividend may have been earned in a prior year and may still remain unpaid, the Board has the right to pay dividends out of the earnings of a subsequent year to the several classes of stockholders, including the Preferred B and the common, in the order of their respective priorities.

We do not agree to any one of these three points. A non-cumulative preferred dividend for any year to the extent that it is earned in that year is no more inchoate and unenforceable than a cumulative dividend. A non-cumulative preferred dividend to the extent that it is earned in a particular year is not lost if not declared within the year, but forms the basis for a dividend credit to the extent that it is earned. No junior dividends may be paid out of the earnings of the subsequent year or the general surplus or any other fund until after the Preferred A dividend credit is first satisfied.

In so far as Petitioners' claims (a), (b) and (c) are based upon the use of the word "non-cumulative", it should be noted that there is nothing in any of the authorities cited above which sustains that view. Petitioners do not discuss or even mention these authorities. They agree, we assume, that preferred stockholders whose dividends are non-cumulative are not entitled to receive more in dividends in and for any year than the amount earned on their stock in that year.

Both Petitioners and Respondents rely for their respective positions, not only upon the word "non-cumulative", but also upon the particular language of the charter provision other than the word "non-cumulative". It is therefore necessary to examine that language.

II.

Analysis of the language of the contract other than the word "non-cumulative".

The contract is quoted above at the beginning of the argument. It grants to the Preferred A stockholders the right to receive preferential dividends in each year up to the specified amount before any junior dividends are paid. It says nothing whatever about the distribution of the earnings of any particular year, prior, present or subsequent. It grants to the A stockholders a priority in payment of their dividends over junior dividends to the extent of the dividends which the Preferred A stock is entitled to receive.

On page 35 of the Petitioners' brief the contract is analyzed in several items (a) to (i) inclusive. We admit the statements made in that analysis. On page 36 of their brief Petitioners comment upon these several items. We comment upon them as follows:

(a) The Preferred A dividend is "preferential" but not guaranteed or made a charge upon any earnings, any more than a cumulative dividend is made a charge on earnings.

(b) Each fiscal year is a separate accounting period to determine the amount of the non-cumulative dividends which the Preferred A stockholders are entitled to receive in and for that year, but not for any other purpose.

(c) The preference is not limited to dividends which may be declared by the Board in the exercise of its ordinary discretion. The dividend right is given by the contract, not by any dividend declaration. The contract provides that the Preferred A stock

"is entitled to receive preferential dividends in each year".

This is vitally different from a contract providing that the Preferred A stock is entitled *to a preference in the payment of dividends in each year.* Under such a contract the preference might not be called into existence until the dividends were declared.

(d) The quotation from *Black* (Petitioners' brief, p. 29) may be correct when applied to a grant of *preference in payment* of non-cumulative dividends, but, when applied to the Wabash contract the statement that the preferential dividend right is extinguished by failure of the Board to *pay* the non-cumulative dividend in any particular year cannot be reconciled with the authorities cited above, which are unanimous in reaching a contrary conclusion.

(e) We agree that the right given to the A stock to *participate* with the common in excess dividends is dependent upon (1) a declaration by the Board exercising its discretion, which (2) must be made in that year. Whatever may be the force and effect of the use of the phrase "declared by the Board" in this connection, it is used in the contract in defining its right to *participate* in excess dividends and it is not used in that part of the contract which defines the preferential dividend rights conferred upon the A stock. The draftsman knew very well how to use that word and if he had intended that the preferential dividend right should be dependent upon a dividend declaration he would have said so. His failure to do so evidences a contrary intention.

(f) The contract provides that the A dividend rights in liquidation are dependent upon dividends thereon *declared* and unpaid. Here again in this connection the draftsman used the word "declared".

(g) Again the draftsman used the word "declared" in providing for distribution on liquidation and the same comment presented in (e) and (f) again applies.

(h) The same comment again applies based upon the use of the words "declared" and "unpaid" referred to in Petitioners' (h).

(i) We deny that the provision therein referred to granting a preferential dividend right to the B stockholders is susceptible of the interpretation placed upon it. This provision is quoted on page 38 of petitioners' brief with some words inserted in parentheses which do not appear in the original charter provision. There is an error in the fifth line of this quotation in the phrase

> "after payment of the full five per cent. *dividend* on the five per cent. profit-sharing Preferred Stock A."

In the *certificate of incorporation* of the Company (see Exhibit A to the Bill) in the second paragraph of Article Fourth (Trans., bottom of page 10), the word is "dividends", that is, the plural instead of the singular. Before any of the preferential B dividends may be paid the Preferred A stockholders are entitled to receive all of their preferential A dividends, not only those for the current year but, in addition, those earned in prior years which still remain unpaid.

It is true that the *stock certificate* issued to represent the Preferred A stock uses the word "dividend" instead of the plural (Trans., p. 18, l. 8) but that was evidently a clerical error. This certificate, contains the following:

> "Reference is hereby made to the Certificate of Incorporation of the Company *to all the provisions of which this certificate and the rights of the holder of stock represented hereby are subject,* for a statement of *the rights and privileges of and the limitations upon the various classes of the Company's stock and of the obligations of the Company with re-*

spect thereto and for its provisions generally as if herein set forth in full" (Trans., p. 19).

The *certificate of incorporation* controls.

The contract does not limit to five per cent. in a given fiscal year the amount of preferential dividends which must first be paid on the Preferred A stock, before any dividends may be paid on the Preferred B stock in such year.

On page 37 of petitioners' brief we find the following in italics:

> *"It is respectfully submitted that the stipulation that the Preferred B stockholders are entitled to dividends up to 5% in any year in which the full 5% dividend is paid upon the Preferred A stock is alone determinative of the present case."*

This is not an accurate statement of the preferential dividend right conferred upon the Preferred B stock. This paraphrase indicates that the B stockholders are entitled to their 5% *in any year in which* the A stockholders have received 5%. We deny that this is a proper paraphrase of the language of the contract which appears in the Transcript at the bottom of page 10 and the top of page 11. The condition precedent to the payment of any B dividends in any year is that all of the A dividends for that year, and in addition all of the A dividends earned in prior years which still remain unpaid, shall be first paid and satisfied.

We have discussed the force and effect of these provisions of the contract because petitioners seem to rely upon them with so much confidence. In its application to the facts of the case it is not of any particular importance, for it relates only to the status of the preferential B dividend and there is a very small amount of B stock outstanding. There

is no provision in the contract authorizing the payment of common dividends after payment of the full A and B dividends, similar to the provision authorizing the payment of B dividends after payment of the full A dividends. It therefore follows that, even if the B dividends are given the preference claimed for them, no common dividends may be paid until after all of the preferential A dividends, including those earned in prior years, are first paid and satisfied.

We are not contending, as suggested in Petitioners' brief, pp. 38-39, that the word "non-cumulative" is employed in one sense when applied to the Preferred A dividends and in another sense when applied to the Preferred B dividends. Both the Preferred A and the Preferred B stockholders are entitled to a dividend credit to the extent that their dividends are earned year by year. The fact that the Preferred A stock is given a right to participate with the Common in certain excess dividends and the Preferred B is given no such right has no influence or bearing upon the right of the A and B stockholders to receive preferential dividend credits.

Petitioners refer to the right of redemption of the A stock and of the B stock reserved by the contract and suggest that according to respondents' theory the Company, in the event of redemption, would have to pay, in addition to the redemption price, the earned but unpaid non-cumulative dividends. That may be true, but the point is not involved in the present case.

On page 41 of Petitioners' brief the statement is made that the two issues of preferred stock were made non-cumulative, so that the Board might have discretion to freely use current earnings for improvements and additions. The Board would have that same discretion if the dividends were cumulative.

In that event the preferred stockholders would have been entitled to a dividend credit to the full extent of the 5%, but, as in the present case, the A dividends being non-cumulative, the dividend credit in favor of the A stock is limited to the amounts earned upon said stock year by year.

If the last clause of the contract, which provides that the dividends shall be non-cumulative, had been omitted and the words "in each year up to the amount of 5%" had been written "at the rate of 5%", the dividends would have been cumulative. This is well established by the authorities.

Machen on Modern Law of Corporations, Sec. 551, which says:

> "*Prima facie,* the preference is cumulative."

Cook on Corporations, 8th Ed. Vol. 1, Sec. 273, which says:

> "If preferred stock is issued without any mention of whether or not the dividends are cumulative, then the law makes them cumulative."
>
> *Fidelity Trust Co.* vs. *Lehigh Valley R. R. Co.,* 215 Pa., 610.

It therefore appears that the designation of the dividends as "non-cumulative" cuts down rights which the Preferred A stockholders would otherwise have possessed. Respondents are not relying upon that word as the basis of a grant to them of any preferential dividend rights. They would have had cumulative dividend rights if the last clause of the contract had been omitted.

We submit that the language of the contract, other than the word "non-cumulative", does not sustain Petitioners'

claims, as we have analyzed them above, pages 11-12, items (a), (b) and (c). An alleged discretion vested in the Board is at the basis of each one of these claims. It is therefore necessary to consider the nature and extent of the discretion vested in the Board in regard to the payment of dividends and the effect of the exercise of that discretion.

III.

Discretionary powers of Directors in regard to dividend declarations and the effect of the exercise of that discretion.

Petitioners rely upon the discretionary powers of the Board to defeat the preferential dividend rights which Respondents claim are vested in the A stockholders by the contract. Petitioners insist that it is within the power of the Board to determine whether the A stockholders shall receive their dividends for any particular year, or whether they shall lose them.

Respondents admit, and we believe the Petitioners agree, that the Board is vested with a fair and reasonable discretion in regard to (1) the time of payment of dividends and (2) the appropriation of earnings with which dividends might be paid, to pay for permanent improvements.

The particular point of difference between Petitioners and Respondents is the effect of the failure of the Board, acting in pursuance of a reasonable discretion, to declare and pay non-cumulative dividends within the year in which they are earned and the appropriation of the earnings of

the year to pay for permanent improvements. Petitioners claim that if the Board diverts the earnings of any year, which they might use to pay dividends, to pay for permanent improvements, the non-cumulative dividends for that year, even though they are earned in the year, are lost to the preferred stockholders. Respondents deny that this is true. They contend that the result of such action by the Board is a postponement only in the payment of the dividends and that the right of priority in payment still remains intact. Respondents deny that the Board had any power to modify or control in any particular the dividend rights and preferences given by the contract to the Preferred A stock, excepting only in proper cases the right to postpone recognition of said rights and preferences.

Many contracts which define the respective dividend rights and preferences of several classes of stockholders contain clauses expressly vesting a discretion in the Board in regard to the time of payment of dividends. The language used is very frequently that the dividends are payable *when and as declared by the Board.* There is no such clause in the Wabash contract. We admit, however, that the Board has the power to postpone dividend declarations for any proper reason, but not to deprive the A stockholders of their dividend rights and preferences.

Although we admit that in the interpretation of any contract defining the respective dividend rights and preferences of stockholders the discretionary powers of the Board must be given proper consideration, there are other considerations which also must be taken into account. If, for example, inequitable results would follow from the adoption of a particular interpretation of the contract, the Court will consider carefully whether there is not some more rea-

sonable interpretation. This point was considered in the leading English case of *Henry* vs. *Great Northern Railway Co.*, 1 deG. & J. 606, in which the Court was called upon to determine the discretionary powers of the Board under a contract which defined the respective dividend rights of preferred and ordinary shareholders.

Two interpretations were suggested. The Court rejected one because it would subject the Board to a temptation to favor the ordinary shareholders against the preferred. The Court said:

> "If the directors are, as probably they will be, ordinary shareholders, they will have an interest so from time to time to set aside portions of their funds for the benefit of the company in the next half-year, as to prevent the preference shareholders from receiving a dividend in full, and they will thus create a larger fund for division on the next occasion, the entire benefit of which, on the argument of the appellants, will accrue to the benefit of the ordinary shareholders.
>
> I am aware that it will always be the duty of the directors to fix the amount of the fund retained with reference to the general interest of all classes of shareholders, and not to favor any one class at the expense of the other. But when I see that on one construction of these Acts the legislature will have given to the directors an interest in opposition to their duty, and that on the other construction they will not have done so, I am led strongly to believe that the latter is the sounder interpretation.
>
> The same reasoning is also applicable to the duty of the directors under section 120. There is no time fixed at which dividends are to be declared, and if at the end of any particular half-year the fund for division should be little more than nominal, prudence would, or might, lead the directors to postpone

the taking of any step towards the declaring of a dividend until a subsequent period. But if by declaring a dividend when the fund is merely nominal the claim of the preference shareholder is cleared up to the time of the distribution, it is obviously the interest of the ordinary shareholders that such a declaration should be made, so that here, too, the interest of the directors as ordinary shareholders may be in conflict with the duty they have to perform towards all persons interested, including the preference shareholders.

These anomalies are all avoided if we hold that the preference given by these statutes confers a right to receive dividends at the stipulated rates, not only out of the profits accrued when the dividend is declared, but, if they are insufficient, then out of subsequent profits. On such a construction, which the language well justifies, there can be no inducement to the directors, either unduly to set aside funds for enlarging the works with a view to future profit, or to propose a dividend when there is no substantial fund for distribution. The rights of those entitled to preference will be effectually secured, and the interests of the directors cannot be brought into inconvenient conflict with their duties."

Upon the authority of this case the interpretation of the contract suggested by Petitioners should be rejected and Respondents' interpretation should be accepted for the following reasons:

1. The directors might very frequently find themselves in an awkward and embarrassing position. Near the end of some particular year they will find that a non-cumulative preferred dividend has been earned, but they will hesitate to declare it, because the earnings may be needed for some other purpose which may be very important for the general

enterprise. They will wish to be fair to the preferred stockholders and not deprive them of their earned dividends. On the other hand they will see the advisability of passing these dividends and appropriating the money for some other proper corporate purpose. Their duty to the preferred stockholders will be in conflict with their duty to the enterprise, which is subject to their control. This embarrassment will be eliminated if they know that a failure on their part to declare the dividend within the year will not result in a loss to the preferred stockholders of their dividend right for that year, but will operate only as a postponement of the payment of the earned dividends.

2. The directors would be vested with a very dangerous power. Some of them may own more common stock than preferred. They will be tempted to pass preferred dividends, even though they have been earned, because in that way the dividend right will be lost to the preferred stockholders with a corresponding benefit to the common. These earned dividends will have created a credit to the surplus account, which will always be there for any proper purpose, including particularly the payment of dividends. If the non-cumulative preferred dividends for those particular years are lost, why not pay dividends upon the common stock based upon that credit to the surplus account?

3. The earnings of any particular year cannot be definitely known until after the year is over. It is not at all impossible that during the last few weeks or few days of any particular year very heavy losses may be sustained sufficient to wipe out all of the year's earnings.

4. If the earnings of any year which might be paid as preferred dividends are appropriated by the Board to in-

crease the working capital, or to pay for extensions and improvements to the property, such appropriation may very properly be considered a contribution by the preferred for the benefit of the general enterprise and an investment for their account in the business and property of the Company. The Company may require a larger working capital, or double track, or better terminal or other facilities. Why should the preferred stockholders lose any dividend rights because of that contribution and investment? All that they may properly be asked to suffer is a postponement in the payment of their earned dividends until a favorable time arrives for dividend payments. At that time their preferential dividend rights should be recognized and enforced.

The dividend credit theory presents the proper and the most reasonable solution of the problem and, according to that theory, if a non-cumulative preferred dividend is earned in any year a corresponding dividend credit is given to the Preferred A and no junior dividends may be paid by the Board until after that credit is first paid and satisfied.

The Petitioners use the same argument that we present in this sub-division of our brief. They present on page 42 of their brief two propositions and at the top of page 43 say:

> "A judicial decision construing a contract so as to create such manifest chaos could only be justified by language showing an unmistakable intent."

Their first proposition is that during the years 1916, 1917 and 1918, the Company earned $15,486,352, out of which Preferred A dividends were paid amounting to $2,310,000, leaving a balance to the credit of the surplus account of $13,176,352, of which the Preferred A stock,

according to respondents' theory, is entitled to a dividend credit of $5,283,225 and the balance, $7,893,127 represents the dividend credit of the B and common stockholders. Then follows in 1919 and 1920 operating deficits aggregating $9,918,778. The question presented is whether those deficits should be charged against the A dividend credit or the junior dividend credits or pro rata. The proper answer to that question will determine the amount of the dividend credit, according to Respondents' theory, in favor of the A stock. That question will not become important unless Respondents' position on the main case is sustained. If that should be the result, there will be no difficulty in determining this particular issue. It is discussed by Mr. Berle in his *Studies in the Law of Corporation Finance,* Chapter V, sub-division III, page 101, under the following heading:

> *"The preferred surplus fund must not be diminished by losses until the common surplus fund has been exhausted."*

We believe that that principle will be sustained.

The second proposition suggests that, if Respondents' position on the main case is sustained, there will be outstanding Preferred A stock with eighty-four different values. That would, of course, be an impossible situation. The answer is that it would not be true. Every share of Preferred A stock has the same value as every other share. Each share is entitled to its proportionate interest in the dividend credit. Additional A stock has been issued from time to time with additional common stock in conversion of the B stock under the conversion privilege given in the charter (Transcript, p. 11). It was the intention of the charter that the additional A stock thus issued in con-

version of B should have the same standing as the A stock theretofore issued and should receive the same rights and privileges, including the proper interest in the A dividend credit.

These several influences must be given their proper effect in choosing between the interpretation of this particular contract presented by the Petitioners and the interpretation presented by Respondents. As a matter of fact the present case really stands upon a firmer foundation. The discretion vested in the Board of Directors must be limited to its proper scope. On this general question Mr. Berle in his *"Studies in the Law of Corporation Finance"* uses the following language in his foreword on pages V and VI:

> "Until relatively recently the type corporation was a small concern with a closely knit body of stockholders, generally located near the business and able to stroll down to the plant or call at the office at will. Naturally, therefore, intra-corporate problems were of secondary importance. Today, with the growth of American business, the concentration into large financial units, and the increased liberality of incorporation statutes, the center of interest has shifted. The problems now revolve about financial relationships between the various participants in the corporate enterprise. For one question of corporate entity there are a thousand questions of stockholders' rights.
>
> To facilitate corporate business courts worked out the doctrine that the management should have wide discretion in conducting the business affairs of the corporation, and indulged a heavy presumption in favor of action taken under this discretion. This was fair enough; courts are not in a position to assume large responsibilities in the conduct of business. But with the increasing flexibility of corporate

charters and authorizing statutes, managements sought and secured a new type of power. This was power not to run the business of the corporation as a whole, but to *determine and adjudicate property rights as between the participants in the corporate entity.* The distinction between these two varieties of power is only just attaining recognition. But it is fundamental. Discretion in business affairs involving the enterprise as a whole is one thing; power, or discretion, if you choose to regard it as such, to determine whether or not a stockholder shall have rights in surplus, or what the book value of his stock shall be, is manifestly a horse of a different color. It involves a different relationship: that of control by one group of persons over property rights beneficially vested in another group. And it calls into play many of the considerations applied when equity assumed complete jurisdiction over trusts and uses. It is manifest that problems of procedure and of substantive law must be faced anew; and that corporation lawyers, corporate officials and investment bankers must reconsider their various positions."

The discretionary powers of directors have definite limits. They cannot be extended to include control over vested rights founded on contract.

IV.

Analysis of the cases which discuss the dividend rights of non-cumulative preferred stocks.

These cases may be divided into the following three classes:

A. Cases in which preferred stockholders whose dividends are non-cumulative have *demanded payment* of their dividends earned in prior years.

B. Cases in which the directors have voluntarily declared non-cumulative preferred dividends which were

earned in prior years but still remained unpaid and the common or other junior stockholders have sued to enjoin payment of such dividends.

C. Cases in which the Board has declared common or other junior dividends and the preferred stockholders whose dividends are non-cumulative have sued to enjoin payment.

Cases Under Subdivision A.

These are cases in which dissatisfied preferred stockholders have demanded payment of dividends earned in prior years. They present Petitioners' first two claims, analyzed on page 11, *supra*, that is, whether the dividend right is created by the dividend declaration and whether, if not declared within the year, the dividend right is lost. They do not present the third claim (p. 12, *supra*), that is, whether the Board has the right to distribute the earnings of a subsequent year in dividends, including junior dividends, even though Preferred A dividends earned in prior years still remain unpaid. In none of the cases under this heading do the complaining preferred stockholders ask for payment of their dividends out of any particular fund.

The first case to be considered under this heading is *New York, Lake Erie & Western R. R. Co.* vs. *Nickals*, 119 U. S. 296, 30 L. Ed. 363, in which preferred stockholders, whose dividends were non-cumulative, demanded payment of their dividends simply because they had been earned. The contract provided for the issue of preferred stock

> "entitling the holders to non-cumulative dividends, at the rate of six per cent. per annum, in preference to the payment of any dividend on the common stock, but dependent on the profits of each particular year, as declared by the Board of Directors."

In discussing the meaning of the word "non-cumulative" above (page 9) we cited the *Nickals* case and the definition of "non-cumulative" therein given as follows:

> "non-cumulative, because 'dependent on the profits of each particular year', and not to be fastened on the profits of succeeding years."

This is the only mention of the word "non-cumulative" in the opinion. The decision was based upon other language of the contract. The statement that a non-cumulative dividend is "dependent on the profits of each particular year" is in accord with the other authorities cited above on this point. The statement that the dividend is "not to be fastened on the profits of succeeding years" is not clear. No dividends are fastened on the profits of any year in the sense that they are secured by a lien or charge upon them, unless there is language in the contract other than the use of the word "non-cumulative" which must be given that effect. In the light of the authorities cited above on this point we think that the intention must have been to state that the *deficiency* is not to be fastened on the profits of succeeding years. However this may be, the point is not of any particular importance, for even if Petitioners should establish that the A dividends should not be fastened upon or paid out of the earnings of subsequent years, it does not follow that the preferential dividend rights given to the A stock are lost. Those dividends must be satisfied out of some other fund if not out of the earnings of subsequent years. The Board has the right to sell capital securities to raise the money to reimburse the treasury for the appropriation of earnings to pay for extensions and additions, or the money can be raised by temporary bank loans.

In the *Nickals* case this Court said:

> "The theory of the present suit is that the sum of $1,790,620.71—ascertained to be the 'net profit' derived from the operations of the Company for the fiscal year ending September 30, 1880, after paying operating expenses and fixed charges—*constituted a fund applicable, primarily, to the payment of a 6 per cent. dividend upon preferred stock.* The use of that fund for any other purpose was, it is claimed, a breach of trust on the part of the Company and a violation of rights secured to preferred stockholders, both by the plan and agreement of December 14, 1877 and by the Company's articles of association."

It was shown that the earnings of the particular year had been appropriated by the Board to pay for much needed extensions and additions. This was a matter within the discretion of the Board, for the net earnings of the year did not constitute a fund "applicable primarily" to the payment of the preferred dividend. The opinion proceeded as follows:

> "The Court below adjudged, in effect, that the *right to a dividend,* for the year ending September 30, 1880, payable out of the 'net profit' arising from the operations for that period, *was absolutely secured to preferred stockholders* both by the plan and agreement and by the articles of association. Such, it held, was the contract between the Company and the preferred stockholders, which the Court was not at liberty to disregard. *This,* in our judgment, is an *erroneous interpretation* of both the agreement and the Company's charter. There is *nothing* in the language of either necessarily *depriving the directors of the discretion* with which managing agents of corporations are usually invested when distributing the earnings of property committed to their hands."

The preferential right given the preferred was a preference in payment of their preferential dividends over the common, but not any right to payment out of any particular *fund*, or at any particular *time*.

The Court further said in discussing the agreement:

"• • • That instrument did, indeed, provide for preferred shareholders being paid a dividend of 6 per cent. *before any dividend was paid to common shareholders.* But it was not intended to confer upon the former *an absolute right to a dividend in any particular year, dependent alone on the fact,* or the official ascertainment of the fact, that there were profits in that year, after paying operating expenses and fixed charges. The words of the 13th Article 'as declared by the Board of Directors' do not qualify the words 'dependent on the profits for each particular year.' They should rather be read in connection with the preceding words, 'non-cumulative dividends, at the rate of 6 per cent. per annum, *in preference to the payment of any dividend on the common stock'* • • • We are of opinion, that while the agreement of 1877 and the articles of association sustain the claim of the preferred stockholders to a 6 per cent. dividend *in advance of common stockholders, the former are not entitled of right, to dividends, payable out of the net profits accruing in any particular year, unless the directors of the Company formally declare, or ought to declare, a dividend payable out of such profits; and whether a dividend should be declared in any year is a matter belonging in the first instance to the directors to determine, with reference to the condition of the Company's property and affairs as a whole.* As the evidence shows that the profits for the year ending September 30, 1880, were applied to objects that were legitimate and proper, and as the condition of the Company was not such as to make

> the declaration of the dividend a duty upon the part of the directors, we perceive no ground upon which the claim of the appellees can be sustained."

The net profits of any year may be used in the discretion of the Board to pay the cost of permanent improvements. This does not mean that if so used the preferred dividend right for that year is lost. This Court held to the contrary, for it said in the first sentence of the last quotation that the instrument provided for the payment of preferred dividends

> "before any dividends were paid to common shareholders"

and a little lower in the same quotation for the payment of preferred dividends

> "in preference to the payment of any dividend on the common stock"

and, again, that the Articles sustain the claim of the preferred

> "to a 6 per cent. dividend in advance of common stockholders."

and again, that the preferred stockholders

> "are not entitled, of right, to dividends, payable out of the net profits accruing in any particular year."

There is nothing to indicate that the preferred dividend right for any year is lost because of the appropriation of the earnings, with which they might be paid, to pay the cost of permanent improvements.

In the present case if Respondents had demanded payment of their earned dividends for prior years instead of

asking for an injunction to restrain payment of junior dividends, that demand would have been denied. It is true that there is no "when and as clause" in the Wabash contract vesting express discretion in the Board in regard to the time of payment of dividends, but the contract does not authorize a demand for payment of the Preferred A dividends simply because they have been earned. It grants the right to the Preferred A stock to receive the preferential dividends payable before any junior dividends are paid and this includes A dividends earned in prior years as well as current A dividends.

There is nothing in the opinion in the *Nickals* case which sustains Petitioners' claim that the right to receive a non-cumulative preferred dividend is dependent upon a dividend declaration, and if not declared within the year the dividend right is lost.

Another case upon which Petitioners rely with confidence is *Continental Insurance Co.* vs. *United States,* 259 U. S. 156, 66 L. Ed. 870 (1922). This suit was brought by common stockholders who demanded in the distribution of assets on dissolution an award in their favor of an amount equal to the dividends which they claimed the Board might have declared upon the common stock in prior years. The suit therefore was not brought by preferred stockholders demanding declaration and payment of preferential dividends, nor was the suit filed until after the Company had gone into involuntary liquidation. The case is therefore different from the present case.

The contract is quoted on page 16 of Petitioners' brief. It is very much more elaborate than the Wabash contract and the respective dividend rights and preferences are not the same. If before liquidation the Board had undertaken

to distribute in dividends the earnings of a subsequent year in the order of the respective dividend priorities, including common dividends, even though non-cumulative preferred dividends earned in prior years still remained unpaid, that action under the particular language of this contract would perhaps have been sustained. This Court, speaking through Chief Justice Taft, said:

> "We come now to the issue upon which these appeals were brought here. It concerns the respective rights of the common stockholders and the preferred stockholders in the assets of the Reading Company. * * * (p. 176)
>
> What is to be done is, in fact and law, a liquidation of the assets of the old Reading Company. * * * (p. 177)
>
> The rights of the common and preferred stockholders of the Reading Company *inter sese* are to be determined by the organization agreement of 1896. * * * (p. 177)
>
> Our conclusion that the claim on behalf of the common stockholders is invalid is based on the construction of the words of the agreement itself and hardly needs authority to sustain it. It is, however, in accord with the general common law rule that stockholders, common and preferred, share alike in the assets of a liquidating corporation, if the preference is only as to dividends." (p. 181)

Petitioners quote from the opinion on pages 17 and 19 of their brief. Note the following sentence near the top of page 18 in speaking of the contract:

> "It leaves to the Board to determine in its discretion whether the undivided profits shall be put in surplus working capital or in dividends."

and the sentence near the bottom of the same page, in speaking of this discretion:

> "The failure of the board to exercise it, and the application of the earnings to surplus determine such earnings to be assets as of the time of the compulsory winding up and liquidation of the corporation."

and the further sentence near the top of page 19:

> "The proper interpretation of the agreement is that, after the declaration of dividends for any current year, the undivided earnings are to be regarded as capital assets and to be distributed on liquidation, unless the board of directors has meantime applied them as dividends."

The Court therefore held that the Board at any time prior to dissolution might have declared these common dividends out of the surplus which had been created by the excess earnings of prior years but, under the particular terms of the contract, if no such dividends had been declared prior to dissolution, the earnings at that time became capital assets and subject to distribution as such on liquidation.

A radical defect in Petitioner's claim in this case was that by his bill he demanded payment of dividends and it is elementary that in order to sustain any such demand he must prove that the Board abused its discretion in failing to pay them. No such abuse of discretion was shown.

The case did not involve the respective dividend rights of the preferred and common stockholders. No issue was presented involving the *dividend* rights of any stockholders. The situation in that regard was vitally changed when the Company went into liquidation. The distribution of the

assets in liquidation was expressly provided for by the contract. The basis for Respondents' case is that by the terms of the contract the Preferred A stockholders are given a dividend credit. That credit means a right to receive dividends up to the amount of the credit before any dividends may be paid upon junior stocks. The contract gives no such right to the common stockholders.

No one of the three points analyzed above at pages 11 and 12, representing Petitioners' position as we understand it, was involved in this case.

After discussing the Continental Insurance Company case Petitioners in their brief, page 20, say that the financial structure of the Reading Company is typical of most of the great railroad transportation companies in the country and in a note they cite a great many railroad non-cumulative preferred stocks, and in a note on page 22 they cite certain non-cumulative preferred stocks on which the non-cumulative dividends earned in prior years still remain unpaid, while dividends have been paid upon junior stocks. Each contract must necessarily be interpreted according to its terms and provisions. The fact that there may be outstanding a great many non-cumulative preferred stocks and that on many of them the non-cumulative preferred dividends for prior years were earned and remain unpaid, while the management has inaugurated a policy of paying dividends upon junior stocks, does not assist us in determining the issues presented in the present case.

In *Star Publishing Co.* vs. *Ball,* 192 Ind. 158, 134 N. E. 285, the suit was instituted by preferred stockholders whose dividends were 5% non-cumulative and payable when earned and declared. The contract also contained a preference clause, that no common dividends should be paid until full payment of the preferred dividend. During the period from 1911 to 1918 the Company was prosperous and could

have paid preferred dividends. It was at that time controlled by the owner of a large block of common stock. The bill charged that the directors had abused their discretion in failing to declare and pay preferred dividends and this charge was sustained. The Court said that during this period the Company

> "could have paid dividends on the first days of March, June, September, and December at the rate of 5 per cent. per annum on its shares of preferred capital stock without depleting its cash assets, impairing its solvency, injuring its business or the rights of its shareholders."

The preferred stockholders asked for an award of $62,125 of earned but unpaid dividends. Under the record it was not clear whether the Board had not acted properly in retaining $23,075 as an addition to the working capital The Court held that under the facts a duty was imposed upon the Board to declare non-cumulative preferred dividends for prior years to the extent of $39,050. The Company's position was shown by the following quotation from the opinion:

> "Appellant claims that appellee waived his right to dividends by acquiescing in the use of the net earnings and profits of the Company in paying the mortgage debt. In this appellant is in error. It merely suspended the appellee's right until there was an excess of earnings over the amounts reasonably required to be expended for that purpose. It is nowhere made to appear from the special findings that appellant was in any way prejudiced or misled by the conduct of appellee."

The Board was within its rights in using earnings with which preferred dividends might have been paid to pay the

mortgage debt, but the Court held that the failure to declare those dividends within the year and the appropriation of the money to pay this debt did not result in a loss to the preferred stockholders of their dividend rights, but only in a suspension of those rights until the time came later for the declaration and payment of dividends.

Petitioners endeavor to make some capital out of the fact that certain common dividends had been paid while earned preferred dividends for prior years remained unpaid. It does not appear that the preferred stockholders asked the Company to proceed against the common stockholders for the return of those dividends improperly paid, nor does it appear that there was any assignment of error based upon the payment of said common dividends. The fact that common dividends had been paid was not discussed by the Appellate Court, although it was incidentally mentioned.

There is no discussion in the opinion of the meaning of the word "non-cumulative". The preferred stockholders limited their claim for payment to the amount of preferred dividends earned in prior years.

This case denies Petitioners' first point, that a non-cumulative dividend right depends upon and is created by a dividend declaration, also Petitioners' second point, that a non-cumulative preferred dividend for any year, even though earned in that year, is lost if not declared within that year. Petitioners' third point, that is, the right of the Company to pay dividends to the several classes of stockholders out of the earnings of a subsequent year, was not involved. It is true that the Board had abused its discretion in regard to the payment of dividends. Notwithstanding that fact, the Court held that the Board was justified in using earnings with which dividends might have been

declared to pay a mortgage debt. Therefore there was no abuse of discretion in that act and yet the effect of that act was not a loss of the dividend right, but a suspension only.

In *Burk* vs. *Ottawa Gas & Electric Co.*, 87 Kans. 6, 123 Pac. 857 (1912), preferred stockholders of the defendant Company brought suit demanding payment of their non-cumulative dividends to the extent that they had been earned. Earnings with which these dividends might have been paid had been used to pay for extensions and additions to the property. The contract read as follows:

> "The preferred stock shall carry a six per cent. per annum preferred non-cumulative dividend, payable semi-annually on the first days of July and January of each year after January 1, 1906, out of the net profits of the preceding fiscal year, and a *pro tanto* dividend if such dividend shall fall short of 6 per cent."

The dividends were not made payable when and as declared by the Board, nor was there any clause providing for payment before any common dividends should be paid. The dividends were, however, expressly designated "non-cumulative". The Court held that the obligation to pay the dividends was absolute and that the Board had no right, even to appropriate the earnings, with which they might be paid, to pay the cost of permanent improvements.

The Court said:

> "The fair interpretation of the contract between the corporation and the holder of this stock is that, if in any year net profits are earned, a dividend is to be declared. To hold that the Board of Directors—that is to say, the corporation—has a discretion to declare or not to declare a dividend when it has funds that it can use for the purpose, is to hold that one

> of the parties to the contract has the option to pay something to the other or not, at his own election, * * * "

And again:

> "The directors of the corporation owed a positive duty to pay a dividend to the preferred stockholders whenever in any year there were net profits available. The funds that might be used for that purpose could not rightfully be expended for extensions merely for the benefit of the business, nor could they be withheld to meet the expenses of the next year."

Although the preferred dividend was expressly designated "non-cumulative", the Court held that the Company had no power whatever to appropriate the earnings to pay for extensions and additions to the property, instead of using them to pay the non-cumulative preferred dividends. It was a violation of the preferential dividend right conferred upon the preferred stockholders for the Board to appropriate these earnings to pay for extensions and additions instead of dividends, even though in the exercise of a fair and reasonable discretion the Board no doubt thought that it would be better for the interests of the enterprise to pursue this course. Even though the preferred dividends were designated "non-cumulative", the contract vested definite dividend rights in the preferred stockholders which the Board had no power to disregard.

Cases Under Subdivision B.

These are cases in which the directors have voluntarily declared non-cumulative preferred dividends for prior years and common or junior stockholders have sued to enjoin payment.

In *Wood* vs. *Lary*, 47 Hun 550 (1888), 124 N. Y. 83, the charter provided that the preferred stockholders

> "were entitled to dividends not to exceed 6% payable semi-annually, not cumulative, whenever in any year the net earnings, after payment of all interest charges, shall suffice for payment thereof."

The Company earned dividends over a period of four years, but the Board used those earnings to pay for the construction of permanent improvements instead of paying dividends. The common stockholders sued, alleging that the preferred dividends were non-cumulative and on that account the directors had no right to declare them for prior years. Presiding Justice Van Brunt said:

> "But it is urged that the certificate, being non-cumulative, the directors had no right to declare a lump dividend for four years."

The Court then discussed and distinguished the *Nickals* case on the ground that in that case the preferred dividends were payable "as declared by the Board of Directors". The opinion proceeded as follows:

> "In the case at bar, however, the language used in the certificate is different and seems to confer a right which did not exist in the case cited.
>
> The provision of the certificate is that the holder is entitled to dividends whenever in any year the net earnings, after payment of all interest charges, are sufficient for the payment thereof. This places the question of their rights beyond the discretion of the directors and gives the preferred stockholders a right to these profits as dividends, after payment of the interest charges mentioned in the certificate.
>
> Under these circumstances, whether the directors declared a dividend of these profits arising in each

> year or not, the stockholders were entitled to the same, and perhaps by proper proceedings could have enforced payment of the same at the end of each year. Therefore, the right of the stockholders to these profits became fixed, and even if the directors made no division thereof, that right still existed and could not be taken away. The subsequent compliance by the directors with the terms of the contract in the declaration of the dividend did not, therefore, infringe upon the provision of the certificate which made the dividend non-cumulative."

These non-cumulative preferred dividends earned over a period of four years were declared by the Board payable in bonds, the earnings with which they might have been paid having been used for construction account. The non-cumulative dividends had not been declared within the year, but notwithstanding that fact the Court held they were not lost. These dividends were not paid out of the earnings of a subsequent year, nor out of the general surplus. They were paid in bonds and that course was approved.

It seems quite clear that if, while these earned non-cumulative preferred dividends still remained unpaid, the directors had undertaken to declare and pay common dividends, the preferred stockholders would have been entitled to an injunction to enjoin payment.

The opinion from which the above quotation is taken is the opinion of the Supreme Court, General Term. An effort was made to appeal the case to the Court of Appeals, but the appeal was dismissed because the trial court failed to state the facts found and the conclusions of law, as required by the Code. The Court of Appeals, however (124 N. Y., pp. 87, 88), used the following language in regard to the merits of the case:

"An examination of the questions to which the counsel for the appellant called our attention on the argument led to the conclusion that no error was committed at General Term, but as we have concluded that the appeal ought to be dismissed, the occasion does not call for an expression of the reasons inducing such conclusion."

The next cases to which we wish to call attention are the Cast Iron Pipe and Foundry Company cases in New Jersey, as follows:

Bassett vs. *United States Cast Iron Pipe & Foundry Co.*, in the Chancery Court, 74 N. J. Eq. 668, 70 Atl. 929 (1908), and in the Court of Errors and Appeals, 75 N. J. Eq. 539, 73 Atl. 514 (1909);

Moran vs. *United States Cast Iron Pipe & Foundry Co.*, in the Chancery Court, 95 N. J. Eq. 389, 123 Atl. 546 (1924), affirmed in the Court of Errors and Appeals, 96 N. J. Eq. 698, 126 Atl. 329 (1924);

Day vs. *United States Cast Iron Pipe & Foundry Co.*, in the Chancery Court, 95 N. J. Eq. 389, 123 Atl. 546 (1924), affirmed in the Court of Errors and Appeals by a divided court, 96 N. J. Eq. 736, 126 Atl. 302 (1924).

The Cast Iron Pipe and Foundry Company contract was more elaborate than the Wabash contract in defining the respective dividend rights of the non-cumulative preferred stock and the common stock, but in substance was the same.

The *Bassett* suit was instituted by a common stockholder to enjoin the payment of a preferred dividend earned in prior years and made payable out of a Reserve

Fund, for which Section 47 of the New Jersey Corporation Act provided. The substance of that section is quoted on page 23 of Petitioners' brief. The Company defended its declaration of non-cumulative preferred dividends out of that fund and the Court sustained that position. The common stockholder further contended that the Board had no right to declare non-cumulative preferred dividends which had been earned in prior years. The Appellate Court said:

> "The complainant is a holder of common stock of the defendant company. His contention in the court below and here, was, and is, that the dividends on preferred stock for any fiscal year must be paid out of the profits made during that year; that the profits of any given year which are not distributed in dividends declared in that year belong to the common stockholders, and when distributed must be paid to them to the exclusion of the holders of preferred stock. The defendant's claim is that it may pay dividends on its preferred stock out of any and all surplus net profits, without regard to the period during which they were earned. The learned vice-chancellor who heard the cause adopts in his opinion the contention of the defendant upon this point.
>
> It seems to us that neither the contention of the complainant nor that of the defendant is altogether sound. On the one hand, the corporation has no right to accumulate a reserve fund from earnings which would otherwise be paid out as dividends to the holders of common stock, and afterward use it to pay dividends to the preferred stockholders when the net profits of the year for which the dividend is declared are not sufficient for that purpose. On the other hand, when the reserve fund is accumulated, in whole or in part, by the cutting down of dividends which would otherwise have been paid to preferred stockholders, that fund, so far as it represents

moneys so retained, is available for the payment of subsequent dividends upon the preferred stock. To yield to the contention of the complainant would be to permit the directors of the corporation to defraud the preferred for the benefit of the common stockholders; while to sanction the claim of the defendant would be to put it in the power of the directors to defraud the common for the benefit of the preferred stockholders."

In this case the dividend was declared after the year, in which it was earned, had expired. The dividend right was not lost because of the failure of the Board to declare the dividend within the year.

In the *Moran* case the bill was filed by a common stockholder to enjoin the payment of non-cumulative preferred dividends earned in prior years, out of the earnings of subsequent years, from which earnings the Company had already declared and paid the preferred dividend for that year. The bill charged that the Board had no right to pay more than the full current preferred dividend in any particular year.

The Vice-Chancellor said:

"Section 18 of the corporation act of 1896 (P. L. page 283) provides, as to preferred stock, that:

'The holders thereof shall be entitled to receive, and the corporation shall be bound to pay thereon, a fixed yearly dividend, to be expressed in the certificate, not exceeding eight per cent., payable quarterly, half yearly or yearly, before any dividend shall be set apart or paid on the common stock.'

This obviously means, as to non-cumulative dividends, that out of the profits of any fiscal year, not

> more than the percentage fixed by the charter shall be paid on such stock for such year, but it does not prohibit the Company, after having paid the fixed yearly dividend, from, in the same year, declaring and paying additional dividends out of profits earned in prior years applicable to dividends for such years, and which, but for holding them in reserve for economic reasons, would have been distributed in dividends in those years. These profits belong primarily to the preferred stockholders and the directors are in no wise restricted either as to amount, time or occasion when distribution shall be made."

The decision of the Vice-Chancellor was sustained by the Appellate Court

> "for the reasons stated in the opinion filed in the court below by Vice-Chancellor Backus, 123 Atl. 546."

Here again the dividend declaration was made long after the end of the year in which it was earned and for which it was declared. The dividend right had not been lost because there was no dividend declaration within the year. In this case the non-cumulative preferred dividend was declared out of the earnings of a subsequent year. The dividend right for any year was therefore not limited to payment of the dividend out of the earnings of that year.

In the *Day* case a preferred stockholder sued to enjoin the Company from paying common dividends because non-cumulative preferred dividends for prior years still remained unpaid. We have inserted liberal quotations from the opinion of the Vice-Chancellor at page 7 above and from the opinion of Judge White in the Court of Errors and Appeals at page 8 above. The preferred stockholder was granted his injunction for which his bill prayed. The non-cumulative preferred dividends which formed the

basis for the bill had been earned in prior years and still remained unpaid and the declaration of the common dividend was made after the expiration of said years. That fact, however, was held not to affect the non-cumulative dividend rights and preferences of the preferred stockholders.

The Court of Errors and Appeals was evenly divided in this case. An elaborate opinion was filed by Judge White sustaining the Vice-Chancellor, but no opinion was filed on behalf of the members of the Court who dissented. Judge White's decision shows quite clearly the basis of the dissent. It related to the force and effect of certain clauses in the contract which authorized the payment of common dividends out of the excess earnings of any particular year remaining after payment of the preferred dividends for that year. The dissenting judges argued that these clauses authorized the payment of common dividends out of said excess earnings even though earned preferred dividends for prior years still remained unpaid. Judge White held that these clauses give the Board no right to declare common dividends until not only the preferred current dividends were paid, but also all preferred dividends earned in prior years which still remained unpaid. That conclusion settled the case. Section 18 of the Corporation Act influenced the decision of the dissenting judges, but not the decision of Judge White and those who agreed with him. Neither Section 18 nor Section 47 had any effect upon the decisions of any of these *Cast Iron Pipe and Foundry Company* cases. In the *Day* case the Vice-Chancellor discussed Section 18 and held that it

> "is nothing more or less than a definition of the equitable rights of the preferred stockholders arising out of the Company's obligation to pay the yearly fixed dividend."

Neither statute had any effect whatever upon the Court's interpretation of the word "non-cumulative". That is very clearly shown in the quotations from the Vice-Chancellor's decision and Judge White's decision inserted above, pages 7 and 8.

We have discussed the *Day* case under this heading, although it really belongs under Subdivision C. Our reason for doing this was that it seemed appropriate to discuss all of these *Cast Iron Pipe and Foundry Company* cases at one point.

The next cases to which we wish to call attention are *Collins* vs. *Portland Electric Power Company* in the District Court, 7 Fed. (2nd) 221, affirmed in the Circuit Court of Appeals, 12 Fed. (2nd) 671, and its companion case entitled *Kurtz* vs. *Portland Electric Power Company*, reported with the *Collins* case.

In the *Collins* case the complainant was a common stockholder seeking to enjoin the payment of non-cumulative preferred dividends which had been earned in prior years on the ground that as the dividends had not been declared within the year the dividend right for that year was lost. In the *Kurtz* case the bill was filed by a preferred stockholder seeking to enjoin the payment of common dividends until after all of the non-cumulative preferred dividends earned in prior years were first paid and satisfied. The *Kurtz* case, therefore, just as the *Day* case, qualifies under Subdivision C, but is discussed here because it seems more appropriate to discuss it with the *Collins* case. The preferred stockholders won in both cases.

Judge Wolverton in the District Court said:

> "The board of directors, while authorized and entitled to exercise a large discretion respecting the

time and conditions under which the dividends shall be paid, may not, by any process of indirection, defeat the basic right of second preferred stockholders to payment of interest. * * *

As we have seen, the second preferred stockholders' dividend right to receive their interest prior to the setting apart of any dividend upon the common stock is a basic and primary right, made so by the express terms of the contract."

And again:

"This brings us to a discussion of the primary right of the second preferred stockholders to receive their interest when dividends are declared for payment. In argument the clause 'the dividends upon the second preferred stock shall not be cumulative' is stressed. This is a qualification of the primary right, and is likewise controlling with the board of directors in declaring dividends. The term 'cumulative' is so specifically defined as to need no elucidation. It is thought, in one presentation, to be the antithesis of non-cumulative; that is to say, if no dividend is declared in any one year when there is a surplus applicable, none can be declared in any year later, because it is argued that to do this would be to make that which is declared non-cumulative cumulative. The argument is not persuasive."

And again:

"The board of directors may, if the exigencies demand, set aside such surplus for economical or legitimate purposes, or may allow it to accumulate with earnings of succeeding years before declaring further dividends; but the condition remains that, for the particular year, the second preferred stockholders have earned either a part or the whole of

> their annual interest, and dividends are not declared for payment thereof through the adverse exercise by the board of directors of its discretion in one or other of the instances mentioned above. Payment being thus deferred, what right, if any, have the second preferred stockholders to dividends out of appropriate surplus accumulations that may appear in subsequent years?"

In the Circuit Court of Appeals Judge Gilbert said:

> "The controversy between the parties on this appeal is narrowed to the issue whether dividends upon the second preferred stock are lost if not declared and paid within the year, notwithstanding that there may have been earnings sufficient to pay all or part thereof, or whether the fact that the earnings were made gave to the holders of the second preferred stock a positive right to dividends out of the said earnings, with the result that the directors might lawfully declare and pay such dividends in subsequent years."

And again:

> "In the present case, the directors, by declaring dividends for the years 1921 and 1923, have recognized that the dividends ought to have been declared for those years, and that the condition of the company's property and affairs as a whole justified their later action in declaring them."

These two cases fully sustain the position taken in the present case by the Respondents and deny the contentions of Petitioners. It is important to note that the decision in the *Kurtz* case is directly contrary to contention (c) of Petitioners (p. 12). The *Kurtz* case held that non-cumulative preferred stockholders were entitled to an injunction restraining the payment of a common dividend for a year

in which non-cumulative preferred dividends had first been paid, until such time as the Board of Directors declared and paid earned dividends for prior years on the non-cumulative preferred stock.

Cases under Subdivision C.

These are the cases in which preferred stockholders, whose dividends are non-cumulative, have sued to enjoin payment of common dividends on the ground that preferred dividends earned in prior years still remain unpaid. *Day* vs. *Cast Iron Pipe & Foundry Company* qualifies in this class; also, *Kurtz* vs. *Portland Electric Power Company.* Both of these cases have been discussed with their companion cases under Subdivision B above.

The third case in this class is *Norwich Water Power Company* vs. *Southern Railway Company,* 11 Va. Law Review (N. S.) 203. That case is cited and relied upon by Petitioners. It is exceptional in other respects than that mentioned by Petitioners in their brief at page 33. The contract, which defined the respective dividend rights of the non-cumulative preferred and the common stocks, was:

> "The Common Stock is subject to the prior rights of holders of Preferred Stock at any time outstanding, according to the preferences thereof. The Preferred Stock is entitled to the following preferences and to no other, viz.: In each and every fiscal year after the first day of July, 1895, to receive non-cumulative dividends at and up to the rate of five per cent. per annum in preference and priority to the payment of any dividend on the Common Stock in such fiscal year, but only from the net profits of the Company as such shall be fixed and determined by the Board of Directors and only when and as such Board shall declare dividends therefrom; *but, notwithstanding the preference hereby declared, if, after*

providing for the payment of dividends for any fiscal year on the Preferred Stock outstanding in such year, there shall remain a surplus of net profits of such year, the Board of Directors may declare and pay dividends upon any other stock of the Company for such year out of such surplus net profits.''

The dividend which the bill asked the Court to enjoin was authorized by the express language of the latter part of the contract, that is, the part which we have italicized. That dividend was declared on the common stock in 1924 out of the earnings of 1923, after dividends of five per cent. upon the preferred stock had been declared out of the earnings of that year. Chancellor Crump said:

> ''The second clause commencing 'but notwithstanding the preference hereby declared' unquestionably means that disregarding the fact that to the extent just declared a preference to the dividends in any fiscal year has been given, yet, looking at it as if such preference did not exist 'if after providing for the payment of dividends for any fiscal year on the preferred stock outstanding in such year there shall remain a surplus of profits of such year, the Board of Directors might declare and pay dividends upon any other stock of the Company for such year out of such surplus net profits'.''

This result was required by the express language of the contract other than the word ''non-cumulative''. The Chancellor's interpretation of that word was not necessary to the decision. That interpretation is not in accord with the numerous authorities on the point cited in this brief.

It is interesting to note that one of the authorities upon which Chancellor Crump relied for his interpretation of the word is Machen on Corporations, Sec. 551, which we have

cited above (p. 4) in support of our interpretation of the word. It is difficult to understand the Chancellor's citation of that authority. It is directly opposed to his conclusion.

The present case qualifies in this class. The analysis of the cases would not be complete without reference to the very able opinion filed by the majority of the Court in the Circuit Court of Appeals in the present case. The various propositions presented by both sides were carefully considered and determined. The dividend credit theory upon which Respondents relied was expressly adopted. The entire opinion is important but the substance of the decision is shown in the last paragraph (Trans., p. 117), which reads as follows:

> "The failure of the board of directors to declare Preferred A dividends and the appropriation of the earnings with which they might have been paid to increase the working capital and to pay for construction of extensions and additions, we hold resulted only in granting a dividend credit which, at some postponed date, may be paid to Preferred A stockholders as dividends under the terms of the contract. They are still entitled to receive such dividends and the Board may not pay dividends upon junior stocks until after these earned dividends of Preferred A stock are first paid and satisfied."

V.

The decision of the Circuit Court of Appeals for the Second Circuit should be affirmed.

Respectfully submitted,

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